PROPORTIONATE LIABILITY

AND

CANADIAN AUDITORS

THE HON. W.Z. ESTEY, Q.C.

BRIEF PREPARED FOR
LEGAL LIABILITY TASK FORCE
CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

23 JANUARY, 1996

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY: THE AUDIT EMERGENCY

The office and function of the auditor in this world of corporate and unincorporated group governance, as it exists in the 20th/21st century, is of preeminent importance.

Anything which threatens the availability of the competent, impartial, and independent audit, on an economic basis, is a threat to the integrity of the industrial/commercial/financial complex and to the community itself.

There are many devastating forces abroad which threaten the continued existence of the auditor as we know that institution. The most serious of those forces is the yardstick of legal liability for the auditor's negligence, "joint and several liability." This technical term of law simply means that the auditor is exposed to the risk for the payment of 100% of all the claimant's losses where, on the facts of the case, only 1% of those losses may actually have been suffered by reason of the fault of the auditor. The other 99% in such an example would consist of the damages caused by all the other defendants in the action, who may be, and frequently are, insolvent, or in relation to the judgment damages, impecunious.

A second contributing factor in this auditor's liability crisis arises out of the very nature of the audit function and the reporting process in the regime of the corporate audit and special audit reporting functions in the course of complex corporate procedures relating to insolvency or to merger, acquisition and corporate reorganization transactions. Many defendants are invariably involved in litigation related to these corporate financial proceedings. The scale of such transactions is generally very large. The damages assessed by the courts against all the defendants participating in these procedures is on the same large scale.

Adding "joint and several liability" for all participating defendants leads to the almost automatic result that the defendants capable of paying (such as the auditors) bear the heavy consequence of these judgments. Judgments on this scale lead inexorably to the destruction of the audit firm and of the partners individually. This is not a theoretical proposition. Recovery from auditors and others, of losses arising out of such transactions involving the auditors amongst other defendants, has exceeded, in one combination of settlements and judgments in Canada, damages of $125 million (mostly borne by the auditors.) Outstanding court actions or threatened claims in respect of this type of action in Canada are now well in excess of $3 billion. The United States experience, which we are prone to follow in close succession, is even worse.

The alternative to joint and several liability is the principle of proportionate liability for the auditor and the other defendants in the action according to their individual degree of fault as determined by the court. This is the essence of our plea.

The continued existence of a competent audit profession depends on the availability of adequate liability insurance at a reasonable cost. This resource is already in seriously short supply and the cost of this insurance coverage is increasing exponentially. In fact, the major auditing firms in Canada and around the world today are essentially self-insured.

The auditor does not here ask for exoneration from fault for his or her wrongs. Under the proportionate liability principle, the individual auditor shall remain liable and responsible for damage or loss actually incurred by reason of the individual auditor's negligence. The assets of the audit firm shall likewise continue to be exposed to the payment of loss actually occasioned by reason of the individual negligence of the partner in question.

Legislative action, at both levels in our federal system, is required. The judicial system can do nothing to alleviate the problem. The responsibility therefore falls upon Parliament and the provincial legislatures to revise the law now applicable to the payment of damages by defendants in this type of action.

We have seen the situation which has developed in this country, in the United States, and elsewhere. Though there may be a time delay before the full impact is felt in Canada, it is reasonable for Canadians to anticipate the same developments in this field which we have witnessed to date in the United States. Action should be contemplated in advance of the impact here so as to minimize the adverse results experienced in Canada when new practices and procedures are introduced here (usually from the United States) without the necessary forerunner of adjustments to our legal institutions.

Legislative action to address this problem has already been taken by the United States Congress and is being seriously considered in both Australia and the United Kingdom.

We believe that proportionate liability should be substituted for joint and several liability in a very limited, discrete area of the law. There should be proportionate liability in all claims against auditors, management, and others for losses arising from defective financial statements and other financial information relating to federal and provincial organizations. We believe that the auditor should have no liability, beyond his or her proportionate responsibility, for any such loss. This is particularly so in the case of business failures where the auditor has become the virtual insurer of all the defendants in legal actions arising from such failures.

We now propose that the following amendment be enacted for organizations subject to federal jurisdiction, such as corporations incorporated under the *Canada Business Corporations Act ("CBCA")*, and financial institutions such as those

incorporated under the *Bank Act*, the *Trust Companies Act*, and the *Insurance Companies Act*:

> **The Court shall in awarding damages for negligence relating to the issuance of financial information by an organization, apportion such damages according to the fault of each defendant and their liability shall not exceed their proportion of the fault.**

The accounting profession is proposing that each province adopt similar legislation for organizations subject to provincial jurisdiction. Each province provides for the incorporation of business corporations and financial institutions such as trust companies, loan companies, and insurance companies. Such provincial organizations are just as susceptible to business failure as their federal counterparts and we believe that joint and several liability should be eliminated, in this very narrow area of the law, on a province-by-province basis.

The real threat to the accounting profession is at the federal level, and it is imperative that legislative action be taken federally without awaiting provincial reform. All but one of the corporations mentioned in the section "II. Claims Against Auditors in Canada" were incorporated under federal statutes and are subject to federal jurisdiction. We are not suggesting, however, that the amendment proposed above would have any application to any of them. The amendment would have no retroactive effect.

This proposal follows the direction of legal and regulatory thought in this country. An interim report issued in December 1995 by the Toronto Stock Exchange Committee on Corporate Disclosure addressed the joint and several issue as follows: "... This issue required little debate by the Committee. In the United States model, one of the clearest incentives to the entrepreneurial plaintiff or attorney is the opportunity to recover from "deep pockets" provided by a system that imposes joint and several liability. ... We strongly believe this approach is inappropriate in Canada because it risks unfairly prejudicing defendants who have little responsibility for a misrepresentation or delay but substantial ability to pay."

The Committee went on to "... recommend that each defendant should be liable only for such defendant's proportionate share of the damages awarded to the plaintiff, *unless* the plaintiff establishes that the defendant *intentionally* made the misrepresentation ..." in which case, the Committee recommended, all the defendants should be jointly and severally liable for damages awarded. To make their report abundantly clear, the Committee expanded on this point: "By proportionate share we mean the portion of total damages that corresponds to the defendant's proportion of the fault assessed by a court."

Both in Canadian studies and in Congressional action in the United States, this rule of joint and several liability has been seen as a form of punishment in the civil law. The principle of proportionate liability is believed to be founded on fairness.

~ § ~

II. CLAIMS AGAINST AUDITORS IN CANADA

Settlements

Auditors' liability became an issue of increasing concern in Canada in the mid-1980s with the collapse of two Western Canadian banks, the Canadian Commercial Bank ("CCB") and the Northland Bank. Actions brought against the officers, directors and auditors of these banks resulted in a settlement of $125 million in 1990 (which did not include a settlement of the claims against the directors of Northland which remain outstanding.)

Actions Pending

Although the CCB and Northland Bank settlements represent the only resolved actions of significance against auditors in Canada, there are a number of claims outstanding in the courts against auditors for billions of dollars. These cases are advanced by the investors, creditors or a subrogated plaintiff such as the Canada Deposit Insurance Corporation ("CDIC") or a United States regulator in relation to a bankrupt U.S. subsidiary.

These claims against auditors include the following:

- An action against a number of defendants, including the auditors, has been brought by the investors and creditors of the now bankrupt real estate financing company, Castor Holdings. The claimants accuse the auditors of failing to detect or to disclose irregularities at Castor Holdings and of grossly misrepresenting the financial picture. Claims total nearly $800 million.

- CDIC has launched a $1.5 billion lawsuit against the former directors, controlling shareholder, and auditors of the collapsed Standard Trust Co. The allegation is brought against the auditors because they signed the financial statements of Standard Trust for two key years.

- A United States regulator has launched a lawsuit for up to $1.8 billion against former officers, directors, and auditors of Confederation Life Insurance Company, as well as a United States bank. The key allegation against the auditors is that they signed the financial statements of Confederation Life for 1991-1993 inclusive even though they knew the company was experiencing severe capital and liquidity problems.

- A class action has been brought against the auditors of Royal Trustco by a group of 1,100 minority shareholders claiming that the financial statements for 1991 and the first nine months of 1992 did not accurately disclose the true state of the company's finances.

In the first example, if the total claim of $800 million were awarded, it would amount to $2.9 million per partner at the auditing firm. Such an award would almost undoubtedly lead to the collapse of the auditing firm, one of the largest in Canada.

Litigation and Insurance

These actions and claims outstanding in Canada threaten the viability of several major audit firms. There is no doubt that there is great cause for alarm. The very existence of these large claims has seriously contributed to the inability of the auditor to obtain adequate liability insurance coverage at reasonable cost. The national firms are facing a three-part problem in insuring against their increasing risk of liability:

(1) The cost of insurance is ten times the cost just seven years ago, and now approximates $35,000 a year per partner;

(2) deductibles exceed $50 million; and

(3) the availability of commercial insurance is severely restricted, having shrunk by 75% in the past ten years, and is available only on international markets.

The major firms are in a difficult position, therefore, as the volume of litigation steadily climbs, and insurance becomes scarcer, costs more, and covers less.

The medium-size and small firms are in a slightly better position because an insurance plan is offered to all members of the Canadian Institute of Chartered Accountants covering members for claims of $250,000 to $10 million with deductibles ranging from nil to $25,000. The number and size of claims against smaller firms have risen significantly in recent years but are not approaching those made against the large firms. The medium-size and small firms as yet do not provide services to the large financial institutions or to many of the public companies, so the losses claimed and suffered are thus far not as great.

~ § ~

III. IMPACT OF LOSS OF THE AUDIT FUNCTION

Impact

If the crescendo of claims and losses in the audit field continues in the next decade at the pace set in the last decade:

(1) Many business organizations, required by law to publish an annual audit of their financial condition, will be unable to do so.

(2) The banks and other financial institutions will be required to curtail lending to business enterprises.

(3) As the supply of auditors dwindles, or the cost of the independent audit climbs, access to credit will generally be narrowed down to those borrowers who are still able to produce an audited report.

(4) The regulator of financial institutions must consequentially revise the inspection and the review of the status of licensed financial institutions.

(5) Whole new approaches for the raising of capital will be required to replace some of the credit sources presently open to the business world.

(6) Auditors will not be available to assist directors and others with their rapidly expanding corporate governance responsibilities.

The dangers and difficulties are now known. They have one thing in common: these problems have all arisen under the rule of joint and several liability as it has been applied by the courts with reference to the liability of the auditor and of the other defendants in the same action.

Public Interest

Clearly, the liability crisis faced by Canadian auditors has serious implications for the community that far transcend the wreckage brought about by the collapse of an accounting firm or the personal bankruptcy of individual professionals. Any deterioration of the audit function will inevitably impact detrimentally upon the community at large because of the important role the auditor plays as gatekeeper of the commercial world.

Unfair System

A legal system that forces innocent defendants to settle rather than defend themselves in court, and a system of liability that allows, and indeed requires, a court to assess damages against an individual who did not cause them is transparently wrong. Such a system demands the attention of a larger group than those directly impacted by the inequity, and it must be reformed to provide fairness and balance and attain the integrity of our legal system generally. When this wrong is coupled with

potentially devastating effects on the community at large, the historic role of the legislature comes into play so that a better and fairer system can be installed quickly. The damages are known, the losses are accruing. A delay in implementing a solution to this problem will itself enlarge the harm to the community as a whole.

Value of the Auditing Function Generally

Role of Audit

The process performed by the auditor adds credibility and fosters confidence and trust in our financial and economic system. It allows capital to be allocated to where it has the highest return and is a cornerstone of a free market system. The audit plays an essential part in ensuring the integrity of corporate reporting which is in the interests of the business community and its international competitiveness and reputation.

The very real threat posed by unlimited liability to the accounting profession's long term survival has most serious implications for the independent audit function, the financial reporting system, the capital markets and the well-being of business and the public generally. In short, the efficient allocation of capital fuels economic growth, capital markets depend on reliable financial information to operate and financial decision-makers, in turn, depend upon the independent auditor for assurance that the information is, in fact, reliable. The auditor is therefore an essential component of our capital market system.

Increased liability for auditors threatens the ability of accounting firms to continue to provide the audit function to Canadian enterprises. This threat manifests itself in four forms:

(1) decrease in the availability of traditional and extended audit services;

(2) inability to attract quality candidates to the profession;

(3) increased cost of audit services; and

(4) limitation on the ability to procure auditing services for companies deemed to be "high risk".

Impact on Services

Fear of undue and unknown liability has made auditors generally reluctant to assume new responsibilities relating to such areas as assurances on forward-looking data and additional financial disclosure. Although the accounting profession has the expertise and the objectivity to provide assurances to the public regarding many of these new types of information, the increased liability discourages auditors from undertaking this further role which would, if provided, assist intelligent investor decisions. Expanding the liability of auditors artificially, through a rule of single-defendant liability for the collective liability of all the defendants (by joint and several

liability,) regardless of fault, impacts negatively upon the knowledge base of the investing community. Auditors are loath to provide information or assurances above the statutory minimum for fear of incurring additional and yet-more-unreasonable liability.

Impact on Profession

The prospect of a large firm failure and of liability which greatly exceeds the amount of damages attributable to the auditor has caused apprehension about personal financial risk among those considering making a career or accepting partnerships in firms which undertake audits, whether those individuals would join as auditors or otherwise. It will therefore become more and more difficult to attract and retain the best people. Any decrease in the quality of people entering the profession would soon filter through into the quality of the audit work performed.

One cannot expect these experienced professionals to magnanimously expose their families' personal assets to unjust liability simply to ensure the provision of necessary audit services to Canadian companies.

Increased Cost

In a global economy, an excessive legal liability climate can put a nation at a competitive disadvantage for several reasons. Higher insurance and liability costs drive up the price for goods and services, in this case the audit service. As a result, countries that have a less litigious climate will be able to more cost-effectively export their products than countries where the liability problem is significant. Investors and entrepreneurs may simply turn to foreign markets where the cost of doing business is lower. Canada will be placed at a competitive disadvantage to other countries with more rational liability systems and measures to reduce the proclivity of the plaintiff class for litigation.

Withdrawal of Services

The legal liability climate is causing an increasing number of large firms to avoid high-risk audit clients and even entire industries. The firms are wary of start-up businesses, high-tech firms and the financial services sector. Risky though some of these may be, they are a vital part of economic development. Without audited financial statements, a company cannot go to the public securities market for capital and may not be able to acquire a needed bank loan. As a result, economic growth will be restrained. Developing ideas will go elsewhere, and take the associated job prospects with them.

This trend started in the United States where, for example, the managing partner of Arthur Andersen & Co. in the US stated that his organization has either dropped or declined to audit more than 100 companies over the past two years. KPMG Peat Marwick is currently dropping 50 to 100 audit clients annually. As the chairman of Deloitte & Touche has indicated, "no risky client can pay us enough money to defend ourselves after the client develops problems. We must reduce our legal risks to remain viable."

The same problem manifests itself in connection with Initial Public Offerings (IPOs). They are the largest generator of audit-oriented litigation in the United States. Disgruntled investors, after the company's collapse, will commonly bring actions against auditors alleging professional negligence in failing to warn the public of the problems of a troubled client company. The portion of these IPOs audited by the major auditing firms in the United States declined to 75% in 1994 from 84% in 1992.

Effect on Community

For their own protection, faced with extreme liability, auditors are forced to curtail their risk exposure by denying services to a number of new, high-tech and growth companies. It is often these companies who most require the expertise of the outside auditor. However, until auditing firms can be assured of a fair system of liability assessment, they will be obliged to continue to refuse their services to these companies. This refusal could result in the ultimate destruction of a number of new and growth companies but, more importantly, overall will result in retardation of economic growth.

~ § ~

IV. THE RULE OF JOINT AND SEVERAL LIABILITY

What is the present rule of law for tracking the personal liability of the professional auditor? The courts now assess such liability on a basis described as joint and several liability. Put simply, it is a system whereby, when two or more parties are negligent in the performance of their role in the transaction to the detriment of the claimant, the joint and several liability rule enables the plaintiff to recover the entire amount awarded by the court from any one of the negligent defendants without reference to the actual share of fault of the defendant from whom such recovery is exacted. The choice is in the plaintiff. The action brought by the plaintiff is brought against all of the defendants, but any default by an impecunious defendant can be recovered in full from any of the other defendants. It is true that defendants actually paying the plaintiff the losses awarded in the judgment may claim recovery and contribution from the other defendants, but by definition, this right is without remedy where the codefendants are impecunious, hence the search by plaintiffs for defendants with perceived deep pockets. This in practice means the auditor.

Actions Against Auditors

The typical legal action referred to above is one which can be brought by any number of people who may claim to have suffered loss by reason of the commercial failure or other misadventure of the corporation which was the subject of the audit. The plaintiffs who may seek recovery include shareholders, creditors, suppliers generally, corporate managers and officers, perhaps even some or all of the members of the board of directors of the company, regulators who have provided some form of insurance protection to the injured public, and others. The defendants in a typical action will ordinarily include, along with the auditors, management, including senior officers, inside and outside accounting and legal advisors, members of the board of directors, public regulators who were allegedly remiss in their inspection and surveillance mechanisms, and sometimes members of the financial community, including banks who allegedly misled the claimants or some of them as to the financial health of the subject corporation.

Civil Proceedings

We are here concerned with civil proceedings only, and in particular, legal actions taken in the superior courts (courts of general jurisdiction) in all the provinces by individuals and corporations against members of the accounting profession for the recovery of damages for losses allegedly suffered by reason of the breach of legal duties owed by the accountant/auditor to the claimants. These claims may arise under statute or under the general common law, or in the case of the Province of Quebec, under the Civil Code of Quebec. The teeth of judgments of the court in this type of action is the award of damages to the plaintiff by the court.

Around the western world, the extreme claims for damages against the auditors, and in some cases, the actual awards of damages by the courts, have reached enormous proportions in the last few years, even on the scale to which we are

becoming accustomed in today's judicial world. In Canada we have seen two extensive claims arising out of bank failures where settlements, which are not yet completed, are in the range of $125 million. These are said to be the largest civil settlements of outstanding actions in Canadian legal history.

In the past few years, these claims and awards have threatened the very viability of the accounting firms, particularly those engaged in performing the audit function. The claims and awards already experienced far exceed the net worth of the firms and of their partners and can or could be met only if adequate insurance coverage is available.

The actual court proceedings taken in Canada, the United States, the United Kingdom, and Australia are summarized in section II and Appendix D.

Insurance

Professional liability insurance has, to some extent, filled the gap and made possible the satisfaction of these claims in Canada and elsewhere thus far. As a consequence, however, such insurance is either no longer available on a scale commensurate with claims and actions in progress or threatened, or is available only at a prohibitive premium cost.

In summary, it is safe to say that the dramatic threat to the audit profession arises principally because of the combination and interaction of the trend toward:

(1) enormous damage actions in connection with large-scale corporate operations;

(2) the escalating and amplifying effect of the doctrine of joint and several liability amongst all defendants; and in turn,

(3) the attraction of the plaintiffs to the doorsteps of the auditors and their insurers because of the joint and several liability doctrine.

The effect of these developments has been, in essence, to force the auditors to become the insurers *de facto* of all the other participants in these financing transactions. In the result, therefore, the auditor must attempt to carry adequate liability insurance to cover all defendants, but has been unable to do so on the scale required in the litigation surrounding these large financial transactions.

U.S. Experience

It must be remembered, in assessing the magnitude of the threatened or actual court proceedings for recovery of economic losses from auditors, that legal and financial conventions, practices, and principles arising in the United States are almost invariably transplanted into Canada through somewhat comparable political and legal institutions. In short, the American storms in very large-scale financial and corporate transactions invariably turn up in our "weather forecast." The auditor in Canada, therefore, must, if he be realistic, take into account the almost certain arrival of like

large and complex commercial litigation in this country and the consequential large-scale awards of damages, payable in reality by the defendants with deep pockets. In turn, it is submitted that the legislators must be equally vigilant in recognizing the need for action now.

Whatever the immediate cause of the financial collapse or other event resulting in losses to shareholders, creditors, and investors generally, it is reasonable to anticipate that similar plans for economic loss recovery in the financial turmoil of insolvency, etc. will be developed in the Canadian corporate world under statute and court processes analogous to those we have seen invoked in the United States.

We submit that Parliament and the provincial legislatures should be alerted to the circumstances prevailing here and in other countries so that the necessary early legislative action can be taken. Statutory relief operative after the deluge has descended will not protect Canadian business from the high cost of the loss or reduced structure of the independent auditing profession in Canada.

Requirements for Audit

The law of the land now, in all parts of Canada, with limited exceptions, requires incorporated businesses to appoint auditors for the performance of an annual audit of the company's financial statements for delivery to the shareholders, securities commissions, and regulatory authorities, and to be made readily available to the public generally. Audited financial statements are also a standard demand by any bank or other agency extending credit to a company or any enterprise, by any regulator who may have surveillance duties with reference to the audited enterprise, and by major suppliers to the subject of the audit.

The commercial community dealing with a business to which members of that community are supplying goods and services or extending credit generally require evidence of creditworthiness when the volume of the business done with the concern in question reaches even modest dimensions of debt or credit. The principal and usually the only source of such assurance comes from the annual or periodic audit reports or special audits by competent auditors.

The Crisis Situation Today

All this is trite. The auditor has been exposed to negligence claims for about a century. What makes the situation critical now? The short answer is the vanishing availability of adequate liability insurance coverage for reasons just discussed. Other considerations are the enormity of the current level of economic loss recovery actions in the courts, access by all claimants to the new judicial procedures such as class actions, and the recent development, here and in the United States, of the tactic of deep-pocket litigation aimed not at the most culpable of the list of potential defendants, but at the one perceived to have the capacity to pay.

The law as it stands today is still evolving in the realm of economic loss recovery and the reach of the judicial arm through the law of negligence in these actions can only be said to be under active judicial review. The courts are not in a

position to remedy the difficulties facing the auditors. Only Parliament and the legislatures can clearly and quickly effect a solution by statutory amendment specifically directed to the present crisis in the audit profession. Recovery from the auditors of all the losses of the plaintiff, however small the share of the auditor's causative fault, is an immoral result and should be rectified by appropriate legislation. All defendants should bear their proportionate share of the damages according to their respective degree of fault. This requires only the substitution of the principle of proportionate liability for the rule of joint and several liability in actions to recover loss by reason of the fault of the auditor.

It is not in the public interest that the present state of the law should prevail.

Legislation Required

A standard of liability at law must be introduced by legislation. This legislative action requires the replacement of the rule of "joint and several liability" by a principle of proportionate liability of the auditor in the computation of losses for which that auditor is to be responsible at law. In short, the auditor's liability must be limited to losses actually occasioned by and flowing from the negligence of the individual auditor, as determined by the court. Once the extent of the liability of the auditor is established using this proportional method, the judgment against the firm and those auditors who were negligent will be satisfied, first by exhaustion of the assets of the firm, and then, if need be, from the assets of the individual auditor who was responsible for the negligence.

Accordingly, we are here concerned only with the adoption of the principle of proportionate liability in the computation of the responsibility of the auditor for losses actually incurred by the claimant by reason of the negligence of the individual defendant auditor. It will then be the role of the court to apply the terms of the relevant statute to the allocation of damages amongst the defendants on a proportionate basis.

Present System

One should pause here and reiterate that the auditor is not seeking immunity from liability or a cap on liability. The audit firm will remain responsible for losses incurred by negligence of the firm where that negligence has been found by the courts to have caused loss to the claimant. All other losses will be borne by the other defendants, again in proportion to their respective fault.

To do otherwise, in simple fact, makes the auditor the insurer of the plaintiff against all losses, however caused, suffered by the plaintiff.

Fairness

In sharp contrast, joint and several liability exposes the individual auditor and his or her assets to the claimants for all of the losses awarded against all of the defendants. It is morally wrong to require an auditor defendant responsible for only 1% of the total losses of the claimant, as found by the court, to pay 100% of the damages awarded against all of the defendants. In the past 15 years, the courts of this country have, more and more, founded the principles of law relating to recovery

of compensation on a simple doctrine of fairness. We find this being applied by the courts to wrongful dismissal, loss of opportunity, the rights of the debtor when faced by demands for enforcement of security by the creditor, and so on. Replacement of joint and several liability by the doctrine of proportionate allocation according to fault is but another step along this pathway of the law.

History of Joint and Several Liability

What is the basis for the Draconian policy of joint and several liability in either legislative policy or the common law? Legal history records two principal attempts at justification:

(1) The courts would find it too difficult to allocate and assign degrees of responsibility where the loss incurred cannot be readily or easily attributable to individual defendants.

(2) The plaintiff must be made whole by the defendants, without regard to the individual culpability of each defendant to pay or contribute. The defendants must be held to this duty on the theory that the possible impecuniosity of any other defendants was a risk knowingly undertaken, at the outset, by the defendants as a group.

The Harshness of Joint and Several Liability

The justification in (1), above, has no validity in fact. The courts are called upon to allocate degrees of responsibility under contributory negligence legislation throughout the English-speaking world. Allocation and assignment of damages is routinely done by the courts and by arbitration tribunals in all manner of areas of the law.

The justification in (2), above, is of course without any application where there is only one defendant. If that defendant is impecunious, the plaintiff is without effective remedy in the law. The courts have shown no concern for this consequence down through our legal history, nor indeed has a legislature taken any action to protect the community from injury from persons without resources, except of course in state-administered and taxpayer-supported schemes such as Workers' Compensation.

This Draconian measure comes into play, therefore, only where there is more than one defendant and only when one or more of the defendants is without recoverable assets. In all other situations, the plaintiff is left with any losses which are not recoverable from the defendants.

The justification set forth in (2), above, is without support for other reasons. Where the defendants are a disparate group gathered in by the accident of their association with the business organization which is the subject of the audit or other review, this group of defendants has no necessary or factual attachment. The only possible commonality of participation would be as members of groups such as shareholders. This would not afford any basis for claiming a quasi-conspiratorial

sharing of a common plan or understanding relating to allocation of liability or otherwise.

Proportionate liability would appear to stand alone as a sensible, fair and equitable substitute for the harsh, rigid, and archaic doctrine of joint and several liability.

~ § ~

V. CONSTITUTIONAL ASPECTS

No Constitutional Barrier

There are no impediments in constitutional law to the proposed introduction of the principle of proportionate liability in assessing the fault and damages payable by the auditor.

The legislative jurisdiction of each of the two levels of government extends to the role of the auditor. There are many provisions in both federal and provincial statutes relating to the role of the auditor in both the specific realm of audit work such as corporate organization, and the general realm of the accounting profession including its professional regulations and licensing system. There may be some subtleties in the allocation of spheres of legislative jurisdiction, but we are not here concerned with any such difficulty.

No issue arises here as to the constitutional validity of any of the long-standing statutes in place in federal and provincial law which concern this subject. We are here concerned with the legislative authority to amend those statutes relating to the auditor's liability in the course of the discharge of the audit function.

Both Legislative Levels Competent

Specifically, this concerns the authority of each level of government in the federal system to introduce the principle of proportionate liability of the auditors for fault in the auditor's discharge of the statutory function of the audit and related accounting services. Where the rule of joint and several liability is presently applicable in assessing the auditor's responsibility for fault, we are concerned here only with the power to replace that rule with the principle of proportionate liability.

There is no doubt expressed in the constitutional discussions in this country of the totality of legislative authority under the Canadian *Constitution*.

Furthermore, there is no uncertainty apparent in the law today about the proper position or authority of each level of government in attending to their particular aspect or interest in the auditor and the audit function. The provinces are responsible for the establishment and for the self-government of the accounting profession. The federal presence is found in the statute of Parliament establishing the Canadian Institute of Chartered Accountants, and in the general system for the development of uniformity of standards and practices in the profession. The federal position also includes direct action with reference to the audit institution itself in federal incorporations and those legislative fields which are exclusively assigned by the *Constitution* to the federal level, as for example the regulation of banks and the incorporation of banks.

In the general regulation of local matters including the licensing and regulating of the profession itself, the province has the authority to attend to all such matters,

subject always to the paramount authority of Parliament in those fields already mentioned where exclusive jurisdiction is assigned to Parliament.

Both Legislatures Competent to Enact Proportionate Liability

Aside from the subtleties of regulatory authority in the fringe areas, it is abundantly clear that both Parliament and the legislatures of the provinces respectively have all the jurisdiction required to introduce a policy of fairness in assessing a standard of conduct of the auditor and the consequential liability, according to fault, in the breach of those standards. The provincial negligence statutes may (and in some instances appear to) set out the mode of calculation of liability for fault by the auditor in the course of the conduct of his or her profession. The federal Parliament has like powers with reference to those parts of the audit function and the office of the auditor which fall within the federal level. For example, by analogy, Parliament has legislated on the subject of the liability of the actuary. Thus, both legislative levels may, within their respective constitutional realms, invoke standards of conduct and consequences in liability according to fault in the event of breach of the prescribed standard.

It may be argued that the courts can adopt the principle of proportionate liability without statutory action. By reason of the doctrine of judicial precedent (referred to as *stare decisis*) and the expense and delay of appeals in each jurisdiction, such recourse is, even without further problems, impractical. Furthermore, some provinces, in their negligence acts, appear to have established the standard of joint and several liability, although the provisions are ambiguous and, at least, unclear. If the courts determine that a negligence act does indeed introduce that principle in the assignment of liability, the judicial system must apply the directives of the legislatures. Whatever the law may be at the moment, it is abundantly clear that recourse to legislative action is the only practical and expeditious way to attain the introduction of the doctrine of proportionate liability in a timely manner, and throughout the country.

It is therefore sufficient for the purposes of this submission to conclude that:

(1) Legislative jurisdiction exists to attend to the plight of the auditor.

(2) Such statutory action must be undertaken at both levels of government to produce the necessary revision in our law relating to the auditor's liability for negligence on a basis completely uniform across the country.

(3) Legislation is the practical mechanism to effect this modernization of the law everywhere in the country with reference to auditor liability, because even if available, judicial reform of this segment of our jurisprudence would be slow and expensive, would lack uniformity, and might indeed fail should the courts elect not to intervene.

The actual amendment of statute law for the introduction of the proportionate liability principle for auditors guilty of negligence in the performance of the audit function may take many forms. One statutory provision which would achieve this result would be to include, in each federal and provincial statute dealing with the auditor's position in law, a simple section designed to fit into these specialized statutes. It is already set out in the opening summary, but is repeated here for convenience:

Wording of Amendment

> The Court shall in awarding damages for negligence relating to the issuance of financial information by an organization, apportion such damages according to the fault of each defendant and their liability shall not exceed their proportion of the fault.

Mechanics of Amendment

In some statutes, either federal or provincial, this amendment may be in replacement of the rule of joint and several liability, as in the case of some provincial negligence acts. In other relevant statutes, either federal or provincial, where the statute is silent as to the mode of allocation of damages as between persons each of whom has been found to be at fault, the provision set out above will operate as an instruction to the courts that damages for which the auditor is liable shall be proportionate to the fault of the auditor, and of the other defendants in the action, which actually contributed to the loss of the claimant. In the absence of this legislative action, the courts will follow judicial precedent and no reform of the present law would be accomplished.

It might be attractive to some draftsmen to attempt an omnibus amendment applicable to all relevant statutes in the respective Parliamentary and provincial fields so that such a provision would be read into any existing statutes and thereby constitute a directive to the courts. This would be an uncertain route, albeit attractively simple, and we do not recommend it.

Parliament has legislated in detail on the role and nature of the auditor in general corporate legislation. It is fair to say that no other office-holder or member of the corporate apparatus prescribed or described in the *CBCA* has received the attention which Parliament has given to the institution of the auditor and the performance of the audit function. The same applies to the interest evinced in all the provincial legislations in the operation of the audit function in a provincially-regulated business. It is reasonable therefore to anticipate that the federal Parliament, along with the provincial legislatures, will have a vital interest in invoking their respective legislative authority to seriously reexamine the adequacy and propriety of the rule of joint and several liability in describing the responsibility of the audit profession in the field of negligence. In short, the legislators must in the final analysis determine whether the replacement of the joint and several liability rule by the principle of proportionate liability is in the public interest.

There is a relevant precedent where Parliament has, in analogous circumstances, exercised its jurisdiction with reference to actuaries in the *Insurance Companies Act of Canada* (s.370(2)). This provision protects the actuary against any liability when filing a report pursuant to a statutory directive; a much more drastic remedy than that which the auditors are now seeking.

~ § ~

VI. LEGISLATIVE OBJECTIVES

The Sole Objective of This Presentation

The time has come to reexamine the basis in common sense and fairness for the imposition of the rule of joint and several liability, whatever its usefulness may be elsewhere and in other times, to the law applicable to the recovery of economic loss from auditors who may be marginally involved in the causes of these commercial losses.

It is not productive to assemble the old judicial precedents and authorities generated in an era far removed from the commercial climate existing in the world today. This is particularly true where the concept of economic loss was not known to the courts at the time the doctrine of joint and several liability was originally evolved in the courts.

The Evolution of Economic Damages in Negligence

It may, however, be productive to consider some of the legal factors or events which have influenced the evolution to the present unsatisfactory state of the law:

(1) Negligence, as a principle of law operating to assist a plaintiff injured by the carelessness of another, evolved very slowly out of the basic primordial action of trespass to the person and to land. For centuries, this evolution moved slowly through the annals of the law. In the courts the remedies were matched to the realities of recovery by the plaintiff under the awards of the court. Large monetary judgments were unknown.

(2) Thus, it can be appreciated that a generalized right to recover damages for a negligent act has not always existed in the law. The law of negligence did not come into play until the courts had located in the plaintiff a right which the defendant had violated. An award of damages had to be assessed in keeping with the prospect of reasonable recovery.

(3) The concept of universal recovery was left to administrative law where specialized tribunals administer a state-operated fund to ameliorate industrial and other losses, as for example Workers' Compensation programs.

Our legal history reveals the early extension of recovery for physical injury to persons who were indirectly or eventually injured by the physical conduct of the defendant. The concept of injury was itself thereafter expanded to include economic injury. All the while, liability insurance grew to cover the class of persons who might be seen as potential defendants in economic recover actions. This, in turn,

produced the economic strength to sustain an enlarged judicial concept of damages to be awarded in actions for the recovery of economic loss.

Litigants today, or their legal advisors, or the courts, have developed the recognition that more targets for bigger claims have been opened up by the combination of the outreach of the principles of law and the theoretical universal availability of liability insurance to protect all against the consequences of negligence.

Legislation Needed

Legislative action today is urgently required and justified because:

(1) the industrial/commercial/financial community needs competent and economically available audit services;

(2) continued application by the courts of the unfair, archaic principle of personal liability for damages without reference to the relationship of the actual negligence of the defendant auditor to the loss actually suffered by the claimant threatens the continued existence of the independent audit profession;

(3) the audit profession will soon no longer be able to attract the highest-qualified candidates because of the high risks now faced by accountants and auditors in the performance of the audit function under laws now uniquely applied to that profession in actions related principally to the audit of business organizations;

(4) the auditor, by reason of the joint and several liability rule, has effectively become the insurer of all defendants drawn into this type of litigation; and

(5) the availability to the auditor of adequate commercial insurance coverage at economic cost is virtually gone.

The Parliament of Canada and all the provincial legislatures may, by enacting the following provision, effectively amend any existing specific statutory enactments, and where the rule of joint and several liability is found in the common law, may by this amendment direct the courts to apply the principle of proportionate liability when awarding damages in this type of action. Such an amendment might take this form:

Proposed Amendment

The Court shall in awarding damages for negligence relating to the issuance of financial information by an organization, apportion such damages according to the fault of each defendant and their liability shall not exceed their proportion of the fault.

This amendment should be introduced into all statutes of Parliament and the provincial legislatures which deal with the audit function or the assessment of

damages relating to the audit function. In the case of federal statutes for example, this will at least involve the *CBCA* and the statutes governing financial institutions, such as the *Bank Act*, the *Trust Companies Act*, and the *Insurance Companies Act*.

This brief deals exclusively with the protection of the audit availability to the community. This, in our view, requires, at a minimum, the replacement of the rule of joint and several liability in actions on the recovery of economic loss involving the auditor and usually other defendants. The principle of proportionate liability must, to do justice to all, apply to all defendants in any such actions.

Other members of the community will no doubt in due course present their case for a wider repeal of the joint and several liability rule. The information at our disposal relates only to the position of the auditor. It demonstrates the pressing need for this important, albeit partial, repeal of the rule of joint and several liability to meet the audit crisis.

~ § ~

This is my report to you on the state of the law, and the proposed reform of that law, relating to the award of damages by the courts and to the recovery of those damages from the auditor and other defendants in actions relating to the issuance of financial information by an organization and the performance of the audit function and related accounting services.

23 January, 1996

The Hon. W.Z. Estey, Q.C.

APPENDIX A

THE ORIGIN OF THE ROLE OF THE AUDITOR

The history of the institution of the auditor continues to influence the present and probably the future legal basis of the office.

Origin

The dim beginnings of today's institution of the auditor in England appear to have commenced in the late 1200s. The process was essentially related to the correction of mathematical and other errors and the review was conducted almost exclusively in connection with the bookkeeping records of public institutions.

Canada

With the passage of the *Ontario Corporations Act*, 1907, the first general mandatory audit provisions in Canada were established. In 1917, federal legislation followed the same line, but it should be noted that neither statute required an income statement as part of the financial statements under audit.

From that foundation onward, the Canadian profession has been largely influenced by developments in the United States. This, in turn, led to a synchronized pattern of securities legislation and rules for the practice of the audit. Differences, inevitably, have crept in over the years as between the generally accepted accounting rules in the two countries, but like labour relations, the differences are more superficial than fundamental.

United States

As the influence of the United States stock exchanges and securities regulators has increased, the similarity between the two worlds of commerce and accounting has increased commensurately. No doubt the advent of the free trade agreements with the United States has also increased this influence. All this has a bearing on assessing trends in the United States relating to audit practices and, in turn, on assessing the impact of these trends on Canadian audit practice and function.

Both in the United States and Canada, the primary requirement of an independent and impartial audit of corporate and other forms of commercial undertakings has been the product not only of mandatory legislation, but also of the extensive demands of commerce, including banking and finance.

The Profession Today

In the end, the North American continent and the United Kingdom have adopted a formal accounting profession with self-imposed rules and principles for the practice of accounting. The audit function has become the exclusive precinct of the accountant, in law in most jurisdictions, and in fact everywhere.

The significance today of the origin and practice of the audit function is examined in several contexts in other sections of this presentation.

~ § ~

APPENDIX B

THE CURRENT SITUATION IN CANADA

Federal

In Canada, many of the changes advocated by the accounting profession have not progressed past the discussion stages. Provincial institutes have made some advances toward legislative reforms to vary the form of organization of the accounting business. As well, there has been some discussion and support at the provincial level for the reform of joint and several liability.

British Columbia

Accounting firms may incorporate and thereby limit their liability exposure only in British Columbia. In other provinces, although some support has been expressed for a legislative reform to limit the liability of auditing firms, there has been no amendment enacted concerning either practice in the corporate mode with limited liability, or for the replacement of joint and several by the proportionate liability principle.

Ontario Law Reform Commission

The Ontario Law Reform Commission ("OLRC") concluded in 1988 that there was no need to reform the principle of joint and several liability. It reported that there was then no empirical evidence to support the contention that such principle is a significant factor "in the diminished availability of liability insurance" or in producing unfairness for defendants. The OLRC concluded that the status quo should remain undisturbed. Their conclusion was based on a policy that the plaintiff must be saved harmless by judicially-awarded damages recoverable from the defendants according to their ability to pay, and not their degree of fault which caused the plaintiffs losses.

In the eight years since the OLRC report, commercial liability insurance has virtually disappeared for the major accounting firms. In that short time, there has been a dramatic increase in the number and size of claims against accountants. A major accounting firm in the U.S. has failed, and there have been individual settlements of claims in the U.S. as high as $400 million. There are now four suits against Canadian accounting firms seeking multimillion-dollar damage awards. This critical situation now pervades the industry and commerce of virtually all the world's trading nations.

There is no indication from the Report that the OLRC turned its collective mind to the consideration of the particularly harsh plight of the auditors. Certainly many of the most serious problems facing the auditors today, as a result of the principle of joint and several liability, had not yet surfaced at the time of the Report. The OLRC Report, therefore, by reason of its timing, fails to give proper consideration to the disastrous impact of this principle on an important part of our commercial world.

Wolff Commission

In Ontario, there has more recently been independent committee support for the limitation of the liability of auditors. The Wolff Commission, comprised of

senior representatives of government, the accounting profession and business, was formed by the Government of Ontario to suggest ways the province might reform its *Public Accountancy Act*. This Commission was chaired by Professor Roger N. Wolff, former Dean of the Faculty of Management at the University of Toronto. Although the limitation of liability was not a topic the Commission was originally asked to address, in the course of its review of the relevant issues, the Commission recognized the need for study of this issue. Professor Wolff recommended that the Ontario government undertake a study of the principle of joint and several liability with a view to substituting a system of proportional liability as between all defendants including public accountants.

Professor *Wolff* reported that considerable evidence was brought to the attention of the Commission indicating that auditors' liability is a very serious and unfair situation which is being urgently addressed in other jurisdictions around the world. He noted that the stability of the profession is being threatened, and viewed this to be a matter of public concern. According to his report, the assurance function provided by public accountants is fundamental to the economic well-being of Ontario and its capital markets. He indicated that it is clearly in the public interest to maintain a strong and viable profession capable of attracting the very best people.

Toronto Stock Exchange Reports

In addition, in 1994 a Toronto Stock Exchange Committee Report on corporate governance in Canada (referred to as the "Dey Commission") indicated the Committee's concern regarding the expanding liability of auditors and expressed a fear that it would impact on the ability of corporations to obtain timely and effective advice. The report stated: "it is ultimately counterproductive to ask advisors to carry unduly onerous liabilities because ultimately these will imperil the ability of the corporation to obtain timely and effective advice" and went on to say "the danger of liability chill ... would be counterproductive to the effective discharge by directors of their responsibilities."

The December 1995 interim report of the Committee on corporate disclosure (another committee sponsored by the Toronto Stock Exchange) addressed the joint and several liability issue as follows: "... This issue required little debate by the Committee. In the United States model, one of the clearest incentives to the entrepreneurial plaintiff or attorney is the opportunity to recover from "deep pockets" provided by a system that imposes joint and several liability. ... We strongly believe this approach is inappropriate in Canada because it risks unfairly prejudicing defendants who have little responsibility for a misrepresentation or delay but substantial ability to pay."

The Committee then went on to "... recommend that each defendant should be liable only for such defendant's proportionate share of the damages awarded to the plaintiff, *unless* the plaintiff establishes that the defendant *intentionally* made the misrepresentation ..." and in which case the Committee recommended that all the defendants should be jointly and severally liable for damages awarded. To make their

report abundantly clear, the Committee expanded on this point: "By proportionate share we mean the portion of total damages that corresponds to the defendant's proportion of the fault assessed by a court."

The Committee, by the clearest inference, associates the rule of joint and several liability with punishment, and proportionate liability with fairness.

Ontario Government

Premier Harris, while a member of the Legislature prior to his elevation to Premier, publicly expressed his support and the support of his party for legislative amendment to allow for limited liability partnerships for accountants. In addition, he confirmed his support for a priority study to replace joint and several liability with proportionate liability. The Institute of Chartered Accountants of Ontario received a letter to this effect dated May 30, 1995 signed by Mr. Harris.

Briefs in Other Provinces

Briefs to provincial governments on the general subject of accountants' liability have been submitted by provincial institutes of chartered accountants in Alberta, Quebec, Nova Scotia, and New Brunswick, and briefs are under preparation in all other provinces.

In provinces where briefs have already been submitted, there is ongoing dialogue between government officials and representatives of the institutes seeking satisfactory legislated solutions on the accountants' liability issues along the lines herein discussed.

There has therefore been some recognition at the provincial level that auditors' liability is an issue which could have a severe impact upon the public interest if left unchecked.

~ § ~

APPENDIX C

DEVELOPMENT OF SOLUTIONS ABROAD

UNITED STATES

In 1988, the American Institute of Chartered Public Accountants (the "AICPA") formed the Accountants' Legal Liability Subcommittee to address the burgeoning legal liability crisis faced by their profession. The Subcommittee studied federal and state laws and attempted to achieve legislative reforms. The auditors' legal liability situation came to a head in the early 1990s with a large number of extremely severe liability cases arising out of the collapse of the Savings and Loan industry. With the efforts of the Subcommittee as well as the Accountants' Coalition formed by the national accounting firms, there have been a number of legislative reforms already adopted and many pending in legislatures across the country.

Federal Initiatives

Since the enactment of the federal securities laws in 1933 and 1934, auditors in the United States have been exposed to considerable liability in the performance of their services. These acts provided a statutory basis for alleging an auditor made a material misstatement either knowingly or recklessly in its approval of the financial statements of the company and these claims provided a basis for finding the auditor partially responsible for the loss of the investor. Once partial responsibility had been found, the principle of joint and several liability was invoked to leave the auditor on the hook for the total damages experienced by the investor with whatever recourse might be taken by the auditor to seek contribution from other defendants.

The Senate Bill

In the past decade, the liability exposure of auditors has increased exponentially. The Senate was the first to react to the liability crisis with the introduction in 1993 of a bill. This bill was reintroduced into current Congress as S.240. In a consideration of the limitation of auditors' liability, one of the most important features of the Senate Bill is the reform of the principle of joint and several liability in securities litigation. Under the bill, joint and several liability is retained for defendants who are primary wrongdoers, who substantially assist primary wrongdoers, or who knowingly engage in fraudulent activity. However, the bill institutes a proportionate liability scheme, based on level of responsibility, for those defendants that are found to be less culpable. On June 28, 1995, the Senate passed the *Private Securities Litigation Reform Act of 1995*", S. 240 by an overwhelming bipartisan vote of 69-30.

Congress

The Senate and the House of Representatives in the United States Congress has now enacted into law a statute which retains joint and several liability only for perpetrating or knowing of the securities fraud. Defendants whose liability is premised on lesser grounds; that is, recklessness; are liable only for their

proportionate share of the damages. The statute was adopted by an overwhelming majority in both the House and Senate.

State Initiatives

Proportionate Liability

There has been some legislation at the state level on the issue of joint and several liability. At present, ten states have abandoned joint and several liability. For example, in Utah, the statute establishes that "no defendant is liable to any person seeking recovery for any amount in excess of the proportion of fault attributable to that defendant." In Alaska, the statute mandates that "The court shall enter judgment against each party liable on the basis of several liability in accordance with that party's percentage of fault."

Modified Proportionate Liability

A number of other states have established proportionate liability generally, while providing exceptions to this rule under certain circumstances. By way of example, North Dakota limits the application of joint and several liability to suits alleging intentional torts, defendants acting in concert and product liability. In Idaho, proportionate liability is generally the scheme but in actions involving agent-principal relationships, two or more defendants acting "in concert", and suits involving hazardous waste or medical devices and pharmaceuticals joint and several liability is invoked.

In other American states, proportionate liability is applied when it is clear that a defendant has not played a large role in causing the injury. In Montana and New Hampshire, for example, the statutes provide for proportionate liability only if the defendant is less than 50% at fault. Other states apply a multiplicity of variations to impose full joint and several liability, when a defendant is largely responsible, in order to avoid placing an unfair burden on a defendant that bears only minimal fault. For example, in South Dakota, liability is joint and several but a defendant who is allocated less than 50% of the total fault "may not be jointly liable for more than twice the percentage of fault allocated to that party."

Although there are still a number of states that have retained joint and several liability, the innovations and reforms undertaken in the states described above indicate that legislatures throughout the United States have considered proportionate liability to be an effective tool for reforming the judicial system.

Limited Liability for Group Practice Members

Limited Liability Partnerships

Perhaps the biggest success at the state level has been in achieving changes to the laws regarding the form in which accounting firms may practice.

A few years ago, the accounting profession in the U.S. began to advocate the adoption of limited liability partnership (LLP) legislation. The first LLP law was enacted in Texas in 1991 followed two years later by the adoption of LLP legislation in Delaware which seemed to give this new organizational form greater recognition. To date, 39 states have adopted LLP legislation. All 50 state boards of accountancy have ruled out-of-state LLPs can practice within their borders, all of the large accounting firms in the US have registered as LLPs, and many local and regional firms have adopted the LLP format. It is estimated that by the end of 1996, virtually every state will have enacted laws for the establishment of LLPs.

UNITED KINGDOM

As early as 1978, the government of the United Kingdom was receiving the recommendation to consider the limitation of professional liability generally. A decade later, a Steering Committee Group prepared the Likierman Report which recommended that auditors be permitted to negotiate contractual limits in connection with specific projects. The Committee further recommended that the issue of joint and several liability be examined by the Law Commission of the United Kingdom.

Incorporation of Accounting Firms

In 1989, the government passed legislation, the *Companies Act, 1989*, allowing auditors to practice as corporations. KPMG, the UK's third largest accountancy firm, was the first to announce its commitment on October 3, 1995 to create a limited liability company, to be called KPMG Audit Plc. to audit 700 of its leading clients. The incorporation of KPMG's audit practice will replace the joint and several liability of audit partners with personal and corporate liability, protecting partners' personal assets from actions for negligence brought against fellow partners.

Limited Liability Partnerships

Furthermore, it was recently announced that Jersey was considering the creation of limited liability partnerships (similar to those already in existence in the United States.) Several accounting firms were expressing interest. They considered LLPs a more attractive option than incorporation. However, neither of these structural changes will address the main threat to the continued existence of the profession caused by the joint and several liability issue.

Joint and Several Liability

The Minister of the Department of Trade and Industry referred the issue in 1995 to a one person reference committee to perform a feasibility study to determine whether the principle of joint and several liability should be visited. The Minister stated:

> "Following discussion with my department, the Law Commission has agreed to investigate the feasibility of a full Law Commission project on the law of joint and several liability focusing particularly, but not exclusively, on professional defendants such as accountants and architects."

The Minister has indicated that the study should be completed soon.

AUSTRALIA

The accounting profession in Australia was one of the first to be alerted to the risk of personal bankruptcy for all the partners in an auditing firm arising out of professional liability claims. A case in the mid-1980's awarded a sum of A$145 million against the defendants, including an auditing firm, and although the judgment was settled in that case, the accounting profession was moved to take action.

Statutory Capping

In response to the urging of the profession, the Ministerial Council in Australia referred the problem in late 1985 to the Companies and Securities Law Review Committee. The Government Committee recommended in September of 1986 that "limited liability for auditors be introduced in connection with the creation of a mandatory insurance scheme". The Ministerial Council endorsed the recommendation and set up a working party, including representatives of the profession. This working party recommended legislation to provide statutory capping based on a multiple of audit fees, to be accompanied by mandatory insurance to the amount of the cap. The Ministerial Council deferred consideration of this capping regime although a capping regime continues to be the solution that the auditors in Australia prefer to limit their liability.

The Report on Joint and Several Liability

In February of 1994, the Attorney General of the federal government, Michael Lavarch and the Attorney General of New South Wales, John Hannaford initiated an inquiry into the law of joint and several liability in response to the concerns among professional groups over large damages awards for malpractice claims and the rising cost of professional indemnity insurance. The final report was publicly released in February of 1995 with the key recommendation that the present joint and several liability of defendants for negligence causing property damage or economic loss be replaced by liability which is proportionate to each defendant's degree of fault. The report noted that negligence principles were developed in the context of personal injury claims and not economic losses, and that the tendency for the common law to seek to attribute loss to one cause alone is not always appropriate where a claim is for economic loss. The accounting profession in Australia is anticipating draft legislation by federal and state legislatures to be released for public comment in the near future.

Incorporation

Under the federal *Corporations Law*, only a person or a firm may be registered as a company auditor, and, therefore, incorporation is not available as an option to limit the liability of auditor. The Federal Attorney General's Department had been working on amendments to the *Corporations Law* to permit auditors to incorporate their practices. These amendments are being considered in conjunction with a review of audit regulation and registration generally being undertaken by a working party appointed by the Federal Attorney General.

The introduction of legislation allowing limited liability partnerships has not been considered a priority of the accountants' task force in Australia during its pursuit of other reform issues aimed at limiting the liability because:

(1) Partnership law is a state issue in Australia and any reform would have to be encouraged at the state level.

(2) Federal initiatives to replace joint and several liability by proportionate liability, and to allow the incorporation of audit firms under the federal corporation law are moving forward.

State Initiatives: Capping

Two states in Australia have made legislative strides separate from those being undertaken at the federal level. In New South Wales, the *Professional Standards Act 1994 (NSW)* was passed with bipartisan support in December of 1994. This legislation provides for the capping of professional liability but ties this limited liability to compulsory insurance and risk management procedures. The *Act* provides a procedure by which an "occupational association" can obtain approval for a scheme which limits the "occupational liability" of members of the association. Practically, it does very little for auditors because there is an exclusion of liabilities under the Corporations Law. The accountants in New South Wales are hoping that this legislation will produce a domino effect throughout the country leading eventually to the implementation of federal capping legislation. Such a result seems unlikely in light of the effort at the federal level to reform the principle of joint and several liability and the reluctance of the federal government to consider the capping regime.

The state government in Western Australia has considered the issue of limiting professional liability since 1991. In the final report of the Select Committee on Professional and Occupational Liability released in January 1994, draft legislation comparable to that of New South Wales was circulated for public comment. This legislation has not yet been enacted.

~ § ~

APPENDIX D

CLAIMS AGAINST AUDITORS IN SELECTED FOREIGN JURISDICTIONS

UNITED STATES

Laventhol & Horwath

The crisis in auditors' liability in the United States is perhaps best exemplified by the situation experienced by the firm of Laventhol and Horwath. In 1990, Laventhol and Horwath, the seventh largest accounting firm in the country was forced into bankruptcy in large measure because of a staggering $2 billion in liability claims and the resulting costs of defending against the lawsuits relating to their role as auditors. The former partners of the firm agreed to pay $48 million toward the liquidation in order to avoid personal bankruptcy.

Settlements

Although clearly one of the most serious litigation losses suffered by auditors in the United States, the situation faced by Laventhol & Horwath is by no means unique. Between 1992 and 1994 four firms settled claims, with the Resolution Trust Corporation and others, which arose out of failed savings and loan institutions, in amounts ranging from $79 million to $400 million and totalling nearly $1 billion. These settlements with federal government bodies, however, pale in comparison to the estimated $30 billion in liability claims being brought in personal lawsuits and class actions outstanding at that time.

Litigation Costs

The major firms in the country indicate that the net cost of judgments, settlements, and legal defense (net of insurance recoveries,) and not including staff and executive time, amounted to $666 million, or nearly 12% of gross accounting and auditing revenues in 1993. As an example of the staggering legal costs faced by accounting firms, KPMG Peat Marwick paid over $7 million to defend itself against a claim, for which they were found to be not liable. It was a claim filed in a Texas court alleging a faulty review of a bank's books. The fee for the audit job was only $15,000.

These major American firms have come to realize that a significant cost of litigation which is never quantified is the consequential diversion of time and talent in the firm. When a lawsuit is brought against an accounting firm, the attention of management personnel must focus on defending the lawsuit instead of running their business.

Insurance

At the same time as litigation costs are rising so too is the cost of insurance protection and its availability, even at these elevated costs, has greatly diminished. It is estimated that the available limits of liability have fallen to well below 25% of their levels in the mid-1980s. Not only have commercial insurance costs skyrocketed but the self-insured retentions, also called deductibles, now exceed $50 million. Although insurance difficulties have mostly been a problem of major accounting firms, industry experts are beginning to warn that small and medium sized firms will experience

higher rates for professional liability insurance over the next few years due to a shrinking in the market of insurance suppliers.

UNITED KINGDOM

The six largest firms in the UK illustrate their liability problem by reference to their insurance claims. In the fiscal year of 1982-83, these firms made three claims against their insurance coverage. In 1992-93, there were 210 claims made with a total of over 600 claims still open at that time. When the possible effect of the BCCI claim against two auditing firms, which exceeds £4 billion, is excluded, the average of the three largest claims over the past years has increased by 12 times. The cost of litigation has risen from 2.6% of audit revenues to 8%.

There have been several major settlements in the range of £40-50 million, including Johnson Matthey Bank, the Maxwell Pensioners, Ferranti and Magnet. In addition to these problems in the United Kingdom, there has been the issue surrounding Lloyd's and certain of its syndicates, including claims involving auditors amounting to about £300 million.

For the period from June 1993 to June 1994, the only amount of commercial insurance available to any major firm in the UK comprises partial cover for losses falling between $45 million and $105 million. The major firms in the United Kingdom report that they are now substantially self-insured.

By a judgment issued 6 December, 1995, the High Court of Justice of England awarded damages against an audit firm for £105 million. The award exceeded insurance coverage by £34 million, for which the partners of the firm are personally liable. This would amount to approximately £200,000 per partner.

To avoid this extreme result, several major firms have looked to the option of incorporating their practices and one has announced its intention to proceed in this direction. However, while this step may protect the uninvolved practitioners from personal bankruptcy, it will not save the firm or the profession from the unfair and potentially fatal consequences of joint and several liability.

AUSTRALIA

In the mid-1980s, a case (Cambridge Credit Corporation) arose in Australia which focused the attention of the accountants in that nation on the risk of personal bankruptcy of all the partners in an auditing firm arising out of a professional liability matter. The decision in the case awarded A$145 million to the plaintiffs in an action against a thirty-partner auditing firm. While the matter was under appeal, we understand it was settled out of court for the amount of the insurance coverage of

A$20 million. Since that time there have been a significant number of claims against auditors in Australia claiming damages ranging from hundreds of millions to billions of dollars.

At the time of a recent tabulation, there were in Australia claims outstanding amounting to in excess of A$6 billion. The State Bank of South Australia has triggered claims of approximately one half of that amount. Other claims, in excess of A$100 million, involve the Australian Securities Commission in connection with Adelaide Steamships, The National Safety Council, The Spadley Group, and The Duke Group. A settlement in 1994 of a claim by the Tri Continental Bank of A$1.1 billion resulted in a payment of A$136 million. This is believed to be the largest payment made in settlement of a civil claim in Australia.

~ § ~